



September 26, 2005

Ms. Mary Rupp  
Secretary of the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, Virginia 22314-3428

Dear Ms. Rupp:

Re: 12 CFR Parts 701 and 741 –  
Uninsured Secondary Capital Accounts

This letter responds to NCUA's request for public comment on a proposal to allow low-income designated credit unions that offer secondary capital accounts to begin redeeming account funds when they are within five years of maturity, and to require prior approval of plans to offer secondary capital accounts.

#### Overview

The Federation supports NCUA's proposal regarding the redemption of accounts that no longer count as net worth. However:

- We oppose requiring prior approval of secondary accounts by regional directors.
- We urge NCUA to eliminate provisions in the proposed and existing regulations that are burdensome to low-income credit unions and/or impose inordinate risk on secondary-capital investors.
- NCUA should permit credit unions with less-than-adequate net worth ratios the ability to prepay, if this will help them generate additional income and thus build primary capital.
- The Disclosure and Acknowledgment statement should be modified to make investors aware of the prepayment risk of their secondary capital investments.

#### Impact on Low-Income Credit Unions

The proposed rule change will help low-income credit unions by giving them greater flexibility to manage their balance sheets, including especially net-worth requirements, by prepaying the portion of secondary capital that no longer counts as net worth. The Federation supports this provision. We commend NCUA for responding to the requests of low-income credit unions for this regulatory change.

However, the proposal imposes excessive paperwork burdens on credit unions and places excessive discretion in the hands of the agency's regional directors. The requirement of prior approval of secondary-capital plans goes beyond previous regulation; it should not be included in the final rule.

#### Adverse Impact on Investors

Since the introduction of secondary capital in 1996, NCUA's successive regulatory revisions to secondary capital have made it progressively more disadvantageous to investors. Admittedly, the basic structure of secondary capital as an investment subordinate to all other claims on the net worth of the credit union makes it a high-risk product. However, this risk has been unduly magnified to such a degree that secondary capital investments may virtually cease to be viable for investors.

- Since the inception of secondary capital in 1996, regulations have stipulated that secondary capital, once captured to cover losses, may never be replenished, even if a credit union returns to solvency. NCUA should eliminate this provision.
- NCUA's rule, adopted in 2000, stipulates that the agency may, at its sole discretion, suspend payments of dividends and principal to secondary-capital investors. This provision should be repealed.

The current proposal, by allowing credit unions to unilaterally redeem portions of secondary capital, adds prepayment risk to the credit, regulatory, and other risks borne by investors.

We do not believe that the interests of low-income credit unions would be well served by discouraging virtually all secondary capital investment; secondary capital has aided many credit unions to achieve safe, robust growth. Nor do we believe that the share insurance fund would be well served by effectively eliminating secondary capital: investors have already absorbed more than \$1 million in losses that otherwise would have had to be paid out by NCUSIF.

We recognize NCUA's role in protecting the interests of the Share Insurance Fund and of credit unions. However, some attention needs to be paid to investor interests, lest secondary capital become so utterly risky and disadvantageous as to discourage any secondary capital investment whatsoever. We urge NCUA to restore a degree of balance between the needs of credit unions, the NCUSIF, and investors

A section-by-section analysis follows.

#### **701.34 Designation of low income status; Offering of secondary capital accounts by low-income designated credit unions**

(b) Offering of secondary capital accounts by low-income designated credit unions

(1) Secondary capital plan.

The existing rules do not require a secondary capital plan to be approved by NCUA. It is argued in the Supplementary Information that secondary capital “played a role in masking the magnitude of other problems,” leading to a number of liquidations, and that consequently, approval of a secondary capital plan is appropriate.

We disagree. We believe that NCUA should reexamine its supervisory procedures rather than adding an additional burden on credit unions. To our knowledge, examiners routinely analyze capital ratios of credit unions both with and without secondary capital. There is no reason for secondary capital to “mask” the magnitude of other problems. Some of the losses referred to by NCUA undoubtedly involved fraud and/or major record keeping deficiencies. Requiring an approved plan will not eliminate fraud. Recordkeeping deficiencies should ordinarily appear in the course of an examination, regardless of the presence or absence of secondary capital. Consequently, we believe that requiring an approved plan will increase the paperwork burden on low-income credit unions without improving safety and soundness or reducing NCUSIF losses.

Finally, we would note that investors have absorbed losses on secondary capital that have *reduced* losses that the NCUSIF would otherwise have incurred on failures of credit unions with secondary capital.

(7) Availability to cover losses.

The regulation should clarify that credit unions may not use any portion of its secondary capital to pay a dividend to members or others. Dividends are not, and should not, be considered “operating losses,” but only can be paid if a credit union has available earnings.

We urge NCUA to withdraw its categorical prohibition on restoring or replenishing a secondary capital account that has been depleted. Subsequent events such as receipt of grants or reversal of charged-off loans may provide a credit union with sufficient capital to repay a secondary capital loan and thereby restore its credit-worthiness.

(12) Prompt Corrective Action

We urge NCUA to retract its prohibition on paying principal, dividends, or interest on uninsured secondary capital accounts established after August 7,

2000. This provision inordinately increases an investor's risk in making a deeply subordinated secondary capital loan to a credit union.

(d) Redemption of secondary capital

(1) Request to redeem secondary capital.

This paragraph should be rewritten to provide greater clarity -- specifically the language stating that requests "must be submitted in writing on an annual basis..." Is the intended meaning that a request *may* be submitted only once in a year?

- (i) Credit unions other than those "adequately capitalized" should also be granted approval to redeem secondary capital, if doing so will improve their profitability and help them to rebuild primary capital.

Secondary capital is often priced higher than deposits (which is altogether reasonable, given the high risk and long maturities of secondary capital.) However, interest payments on secondary capital may drain income that a credit union could otherwise use to rebuild primary capital. Therefore, we urge NCUA to consider requests from low-income credit unions below the two top capital categories to repay secondary capital ahead of schedule.

- (vi) While we do not object to the requirement that a LICU's board adopt a resolution to redeem secondary capital, we are unclear about the reference in the Supplementary Information to "possible conflicts of interest between LICU officials and officials of the SC account holder." Most secondary capital investments are made by investors or funders that are entirely separate from the credit union – e.g., banks, foundations, and government agencies. The proposed language should either be clarified or eliminated from any final document.

(2) Schedule for redeeming secondary capital.

When there is less than one year to maturity on a secondary capital investment, the remaining 20% of the original investment should be redeemable any time during that final year, to ensure consistency with the rest of the schedule.

## **Appendix to 701.34**

### Disclosure and Acknowledgment

We agree that disclosures to investors must be maximally transparent, detailed, and properly executed both by the credit union and the investor. The disclosure must be conformed to the final rule issued by NCUA. By our reading, the proposed Disclosure and Acknowledgment fails to clearly identify the prepayment risk that this proposed rule entails for a potential investor. We urge NCUA to include this information in a revised Disclosure and Acknowledgment statement.

The Federation appreciates the opportunity to comment on this important regulation, and would be pleased to provide any additional information required by your review.

Sincerely yours,

Clifford N. Rosenthal  
Executive Director

National Federation of Community Development Credit Unions  
120 Wall Street, 10<sup>th</sup> Floor  
New York, NY 10005  
Clifford N. Rosenthal, Executive Director  
croenthal@cdc.u.coop